TABLE OF CASES CITED.

	Page
Burnet v. Harmel, 287 U. S. 123	2, 7
Murphy Oil Co. v. Commissioner, 287 U. S. 299	2
United States v. Dakota-Montana Oil Co., 288 U. S. 460	3

TREASURY REGULATIONS CITED.

Treasury Regulations 45	2, 7
Treasury Regulations 69	3

OTHER AUTHORITIES CITED.

I. T. 2384	4

IN THE

Supreme Court of the United States

OCTOBER TERM 1934.

Nos. 176 and 177.

WILLIAM E. HERRING AND EULA DAY HERRING,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

REPLY BRIEF FOR PETITIONERS.

Because of the possibility of confusion which may arise from certain statements in the Respondent's brief, Petitioners deem it advisable to file this reply brief.

Respondent places great reliance upon a strict construction of the phrase "in the case of oil and gas wells"

and contends that the Treasury has consistently construed the statute as not applying to leases covering properties on which no well is in existence. (Brief, pp. 6, 8) The Respondent's position is in error for the following reasons:

The identical phrase "in the case of mines, oil and gas wells, other natural deposits and timber, a reasonable allowance for depletion * * * according to peculiar conditions in each case * * *" has appeared in all revenue acts, beginning with the Revenue Act of 1918. Under all acts from 1918 to date, with the exception of the position now taken with reference to percentage depletion, the Respondent consistently allowed depletion on bonuses, irrespective of the presence of a well. In the Harmel case, 287 U. S. 123 (No. 26 October Term 1932)* the Government argued, without reservation, that bonuses were subject to a depletion allowance and cited as authority Article 216 of Treasury Regulations 65, as amended by T. D. 3938, and *Murphy Oil Company v. Commissioner,* 287 U. S. 299, which was then pending in this Court. The identical article of the Regulations cited is in all prior regulations, beginning with Regulations 45 under the 1918 Act.

Likewise, the word "wells" means, in addition to the drill hole itself, the oil reserve in the ground. The statute involved herein provides for a depletion deduction from the income from the *property.* Discovery depletion provided for an allowance based upon the fair market value of the *property* under certain conditions. Article 220 (a) (3) of Regulations 45, and corresponding regulations under subsequent acts, held that the "property" is the "well." It further held that the well, in addition to the drill hole, included the surface necessary for the drilling and operation of the well and the mineral content of the sand, zone or reservoir from which the production is drawn.** This

*The applicable portion of the Government's argument in its brief in the Harmel case is printed in the appendix hereto at page 7.

**This Regulation is copied in full in the Appendix herein at page 7.

regulation was quoted with approval in *United States v. Dakota-Montana Oil Co.*, 288 U. S. 460, 465.

Early in its brief the Government contends that a well must be on the property in order to permit the depletion allowance on a bonus, but at page 17 does admit that this Court held, in the Harmel case, that bonus payments to the lessor have been deemed to be subject to depletion allowances. We again emphasize that there was no showing of production in the Harmel case. Indeed this Court stated at page 106: "Oil and gas may or may not be present in the leased premises, and may or may not be found by the lessee" and in the light thereof held, under Regulations similar to those here involved, that the lessor was entitled to the allowance on a bonus.

Respondent further argues that a depletion deduction can only be taken when there is production. (Brief, pp. 6, 11) The Department's regulations refute the correctness of this statement. Article 216 (b) of Regulations 69, set forth at page 21 of the Government's brief, specifically provide, with reference to advance minimum royalties, that the depletion deduction shall be taken in the year in which payment is received, and that when so taken can not be allowed in subsequent years when the mineral is actually extracted. As previously stated, the term "mineral property" includes oil and gas wells. If the statements in the Government's brief are correct, sub-divisions (b), (c) and (d) of Regulations 69 are absolutely meaningless insofar as they refer to bonuses, which are specifically mentioned therein.

It is admitted that in the Murphy case there was production on the date of the lease, but nowhere in the Court's opinion is this fact made a test to the right of a depletion allowance on a bonus. The Government argues (Brief, p. 12) that the Murphy case decided that a bonus *may* be subject to a depletion. We submit that the language of this Court specifically states that the depletion allowance *must* be made. The exact language of page 302 is "the bonus or

royalty paid to the lessor both involve at least some return of his capital investment of oil in the ground for which a depletion allowance must be made under section 234."

The Respondent also argues (Brief, p. 12) "That there is a marked difference between advance payment of royalties in anticipation of further production, which is the case when a bonus is paid to the lessor of a producing or proven tract, and a bonus paid for the privilege of prospecting for oil, when there is merely a speculative possibility of success." But he does not state what the difference is. If the allowance is on a percentage basis and in one case there is one barrel of oil extracted, and in another case none, what is the marked difference which allows the entire depletion in one case and denies it in another?

An effort is made to show that I. T. 2384 established a uniform administrative construction that a well must be on the property in order to get the deduction here sought. No effort is made to explain that the practice since 1918 has permitted depletion on a bonus, irrespective of a well, and that the Regulations based on cost depletion still remain as they have been since 1918, irrespective of production.

The Respondent suggests (Brief, p. 15) that Petitioner in later years may derive advantages if their 1926 income is not subject to a depletion allowance, because that allowance reduces the basis for determining gain or loss and thus, in the event of later sale, the profit would be reduced. The argument ignores the realities. The ranch here involved is used primarily for cattle raising. As in most instances, it has been owned for many years, so there is no cost or other basis allocable to the oil reserves, because the mineral deposits were not known to exist on the land at the time it was acquired. In addition the sale of royalties by the fee owner is the exception rather than the rule. The same answer applies to the argument that the Petitioner is entitled to cost depletion—there is no cost to be depleted. Under the specific provisions of discovery depletion, the lessor is entitled to a deduction based on discovery. Per-

centage depletion replaced discovery depletion and it must be assumed that it was not intended to take this deduction from the lessor.

The last argument of the Respondent (p. 20) is that Petitioner did no developing and took no risk; that discovery depletion was to benefit wildcatters, and therefore, lessors should not receive the allowance. Lessors may take a risk by granting leases to wildcatters. If they refrain from leasing until production is reached in the immediate vicinity of their property, they are naturally in a better position to negotiate for larger bonuses. In any event, Congress, in its effort to increase oil production, permitted discovery depletion and specifically provided that the allowance "shall be equitably apportioned between the lessor and lessee."

We submit that in view of the long established administrative practice; of legislative reenactment of the provisions covering "oil and gas wells" in the light of this administrative practice, and the soundness of the rule that advance royalties must be subject to a depletion allowance if income is to be properly reflected, that the decision below should be reversed.

The decision of the Board below shows (R. 13) "No oil was produced from the properties during the taxable year; indeed there was no production until 1930." The Circuit Court found (R. 38) "No wells were sunk on the leased land until 1930, during which four wells were sunk, with the result oil and gas were produced."

Under the view taken by the Board and the Circuit Court it was unnecessary to determine which leases produced and which did not. If petitioners prevail in this case, and the Court believes each lease should be considered separately, we readily admit that, in justice to the Government, the cases should be remanded to the Board with instructions to determine those facts. In that event, if depletion is allowed for 1926 on leases which did not produce, the amount of the allowance may be restored to income for the year of

the termination of the leases in accordance with the recapture provisions of the Regulations.

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November, 1934.

APPENDIX.

Excerpt from brief for Petitioner filed in this Court in Burnet v. Harmel, No. 26, October Term, 1932, page 7:

> "Apparently the court below was impelled to make the distinction because of a misconception which it entertained as to the scope of the depletion allowance. It assumed that a depletion allowance was not made to the lessor with respect to the bonus, while such an allowance was made with respect to the royalty, so that 'this part of his capital is protected and returned'. The assumption that no depletion allowance was permitted with respect to the bonus is clearly erroneous. See Article 216, Treasury Regulations 65, as amended by T. D. 3938, V-2 C. B. 117; *Murphy Oil Co. v. Commissioner,* now pending in this Court, No. 80, October Term, 1932.
>
> Nor is the distinction made below between a bonus and a royalty supported by the cases cited. In every case which has been found where the question was presented it has been held that a bonus does not differ from a royalty, but on the contrary, constitutes a part of the royalty which is paid in advance. * * *"

Later in discussing *Work v. Mosier,* 261 U. S. 352, the Government at page 9 in the brief stated:

> "We submit that this Court did not reach the conclusion that bonuses were advance royalties because of any peculiar provision of the statute involved, but because they constituted 'income from the use of the mineral resources of the land'."

Article 220 (a) (3) of Regulations 45 states:

> "The 'property' which may be valued after discovery is the 'well.' For the purposes of these sections the 'well' is the drill hole, the surface necessary for the drilling and operation of the well, the oil or gas content of the particular sand, zone, or reservoir (limestone, breccia, crevice, etc.) in which the discovery was made by the drilling, and from which the production is drawn, to the limit of the taxpayer's private bounding lines, but not beyond the limits of the proven area as heretofore provided."